Monthly Market Roundup - Debt

January 2009

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Key Events-Global

- US economy continued to deteriorate. Data showed GDP contracting at a better than expected annualized pace of 3.8% in the fourth quarter. Inventory buildup added 1.3% to the GDP growth

- For all of 2008, the economy expanded at just 1.3 percent

- Federal Reserve continuing with a zero interest rate regime indicated at more quantitative easing measures including buying back long-term U.S Treasuries

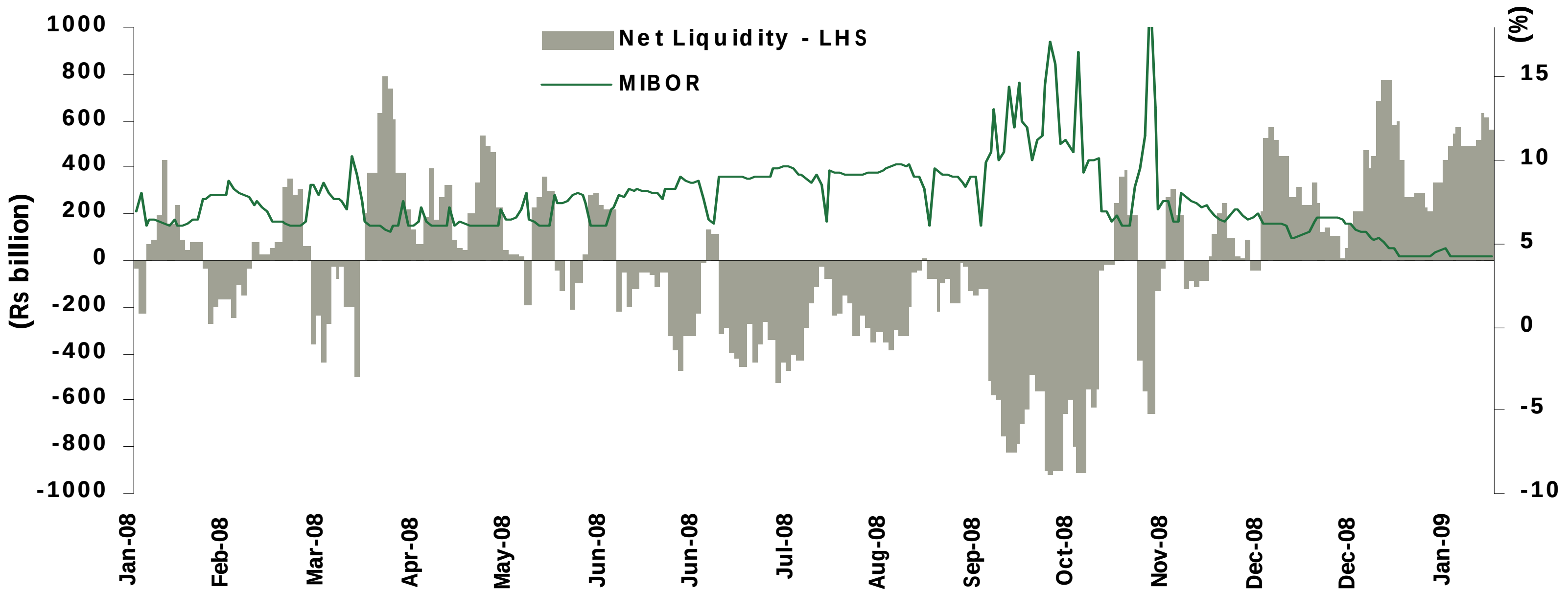
- The UK fell into recession in 4Q with a 1.5% slump in GDP, the biggest in almost 30 years

- Commodity prices continued to decline. Crude oil continues its downtrend, closing at $41.68 a barrel against $46.34 at the beginning of the month

Key Events-Domestic

- Indian macro economic indicators remained weak with exports showing negative growth, though IIP data re-entered positive territory due to some support from a lower base
- The latest International Monetary Fund (IMF) forecasts for GDP growth, project a calendar year expansion of 5.1% in 2009 (down from 6.3% in November 08)
- RBI decided to leave the key policy rates unchanged
- Low overnight rates - NSE MIBOR was trading at 4.23% at the end of January 09
- Key headline 10Yr GoI gradually climbed from a low of 5.25% to 6.25% at the end of the month on worries about additional supply from the Government
- INR remained range bound against the USD over the month trading between 48.5 to 49.1
- WPI Inflation hardened for two consecutive weeks due to a temporary blip in Food prices but continues to ease with the latest reading at 5.64%

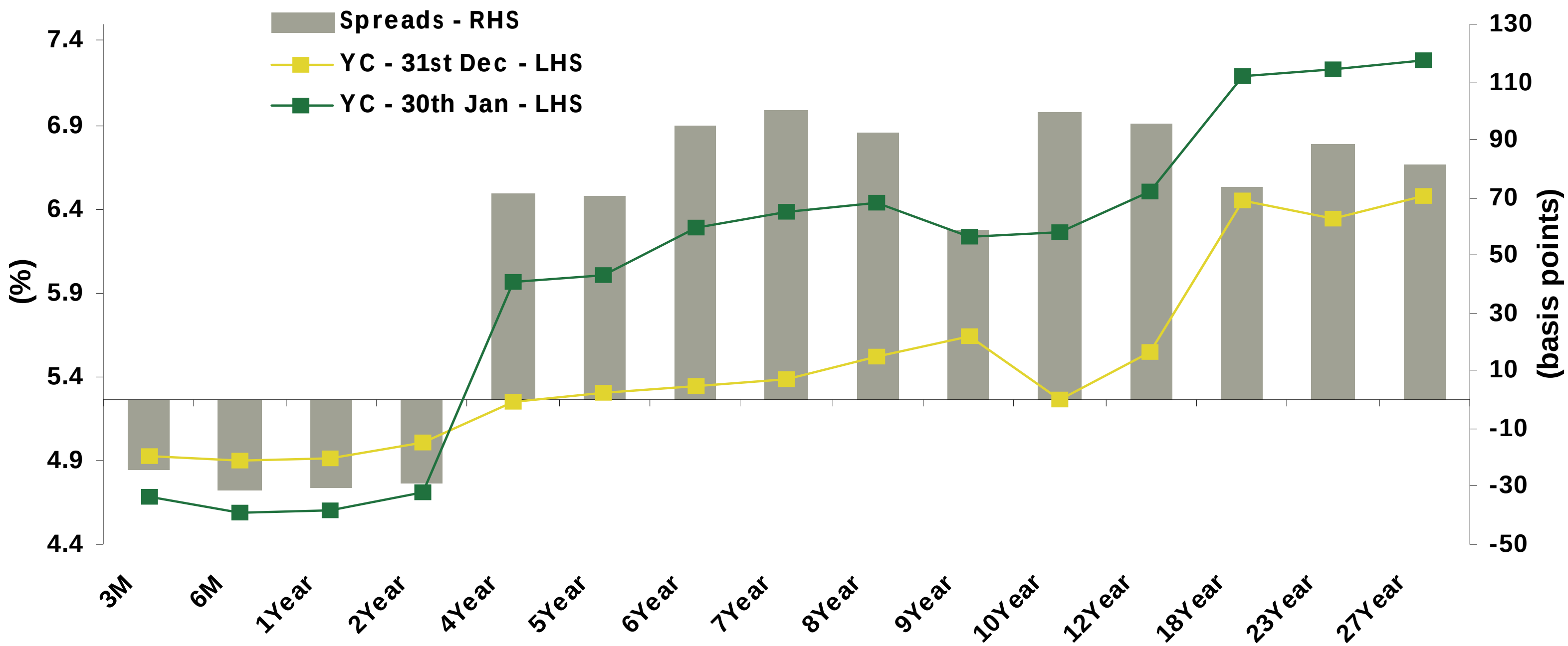
Liquidity – likely to remain comfortable……



Source: Bloomberg

- Liquidity remained comfortable throughout the month
- Average LAF balance during the month was Rs 48000 crores
- Mibor averaged 4.40% in January

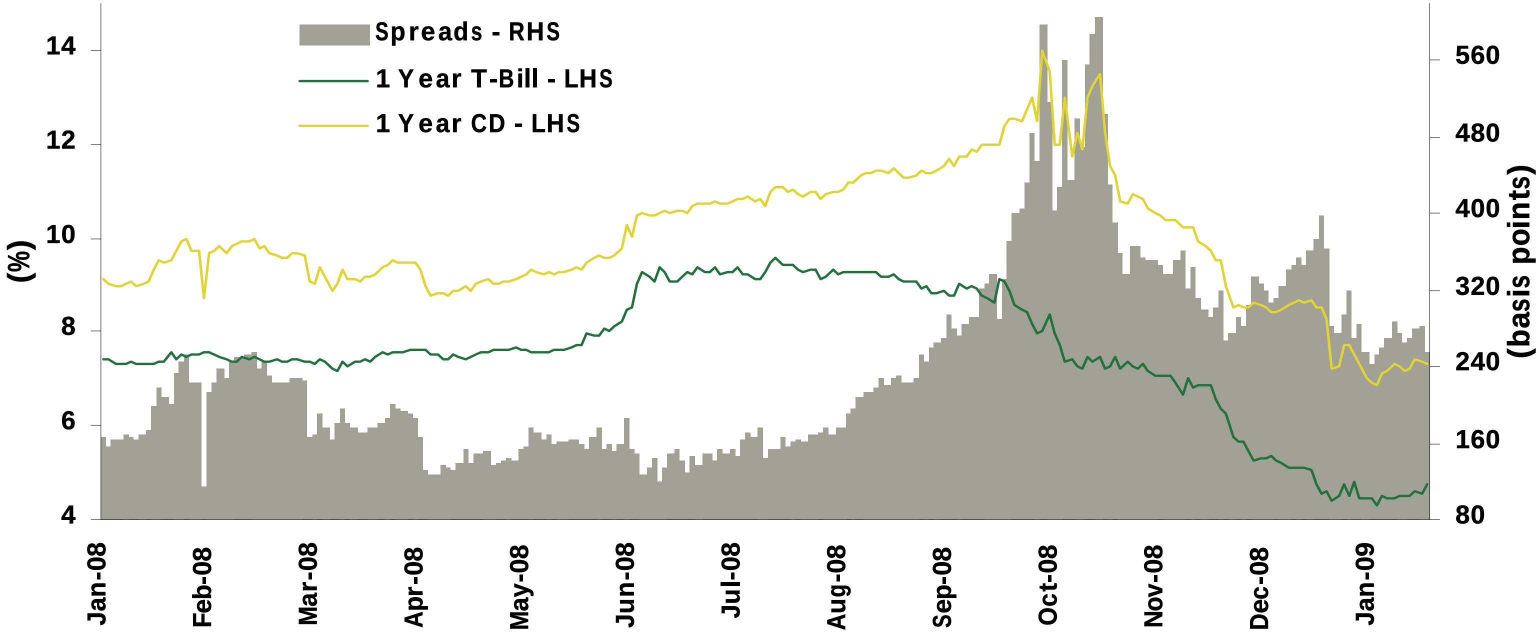
G-Sec Yield Curve – steepened during the month



Source: Bloomberg

- Gilt yield curve steepened as market braced itself for additional supply
- Government issued new 10 year benchmark gilt
- Traders reduced positions as auctions did not see much participation from long-term investors

Money Market- spreads compress over sovereign



Source: Bloomberg

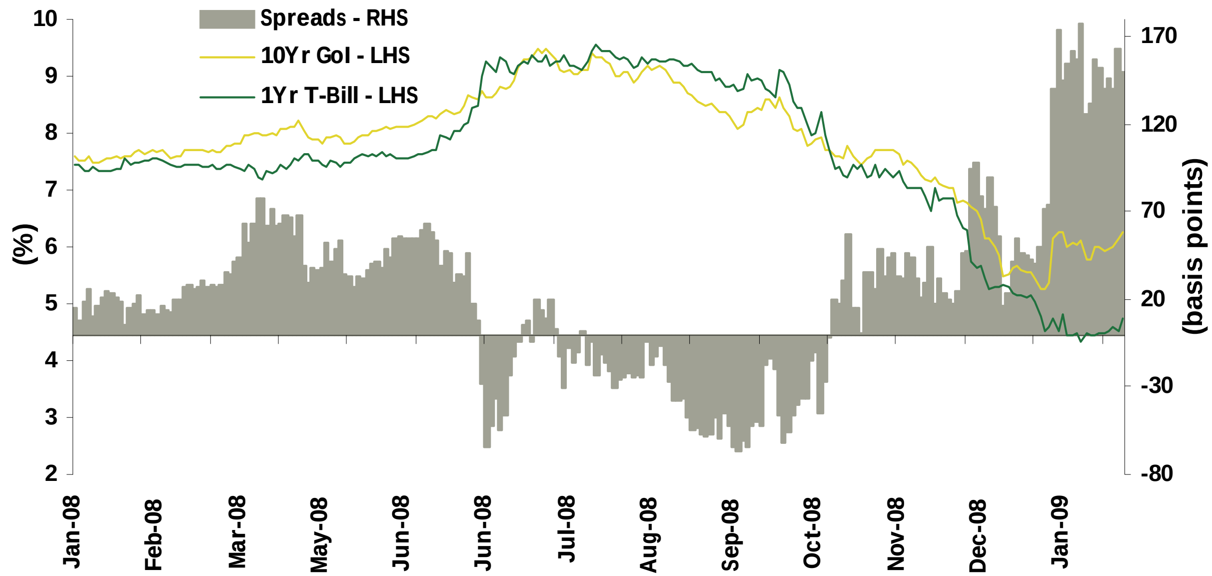
- CD rates were marginally lower in the month and spreads over sovereign saw a marginal compression
- Treasury bill yields rose marginally after easing considerably in the previous month

Corporate Bonds- Sovereign spreads widen marginally

Source: Bloomberg

- Corporate bond spreads widened on the longer end of the curve
- Spreads still remain attractive on continuous supply
- Spreads likely to remain range-bound in the near term and compress over the medium term

Sovereign Spreads- curve steepens

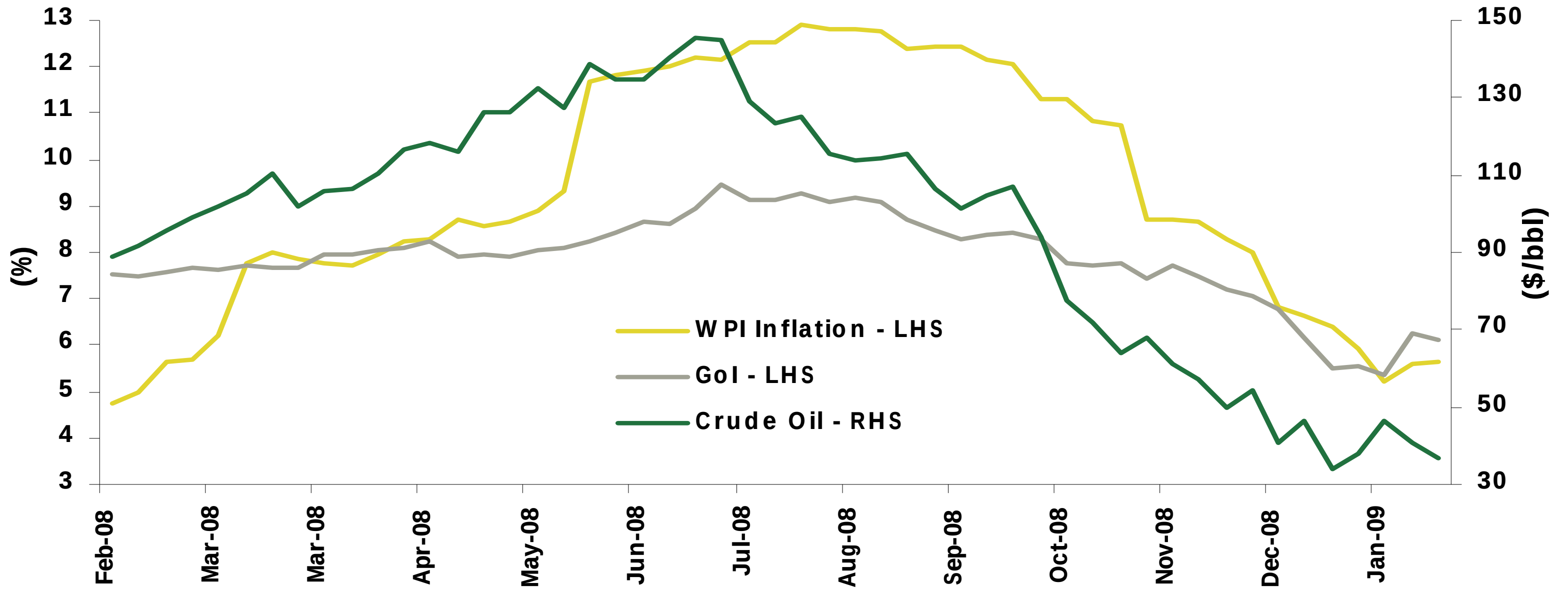


SPREAD SUMMARY	Last I year	Last 1 month
Last (bps)	150.48	150.48
Mean (bps)	25.64	133.30
Off Avg (bps)	124.83	17.18
Median (bps)	-26.26	145.20
StDev	50.7959	34.884
Off Avg StDev	2.46	.40
High (bps)	176.84	176.84
Low (bps)	-66.68	50.24

Source: Bloomberg

- T-bill yields continued to remain low on ample systemic liquidity
- T-bill yields may inch-up a little in case additional government borrowing is concentrated at the short end of the yield curve

Crude and Inflation Dynamics-high correlation



Source: Bloomberg

- Commodity price continued to remain low on weak global headwinds
- USD likely to remain firm against other currencies as risk aversion remains high
- WPI inflation was temporarily higher due to a transporters strike effecting food prices, but is likely to head lower in the coming weeks on domestic fuel price reduction and easing commodity prices

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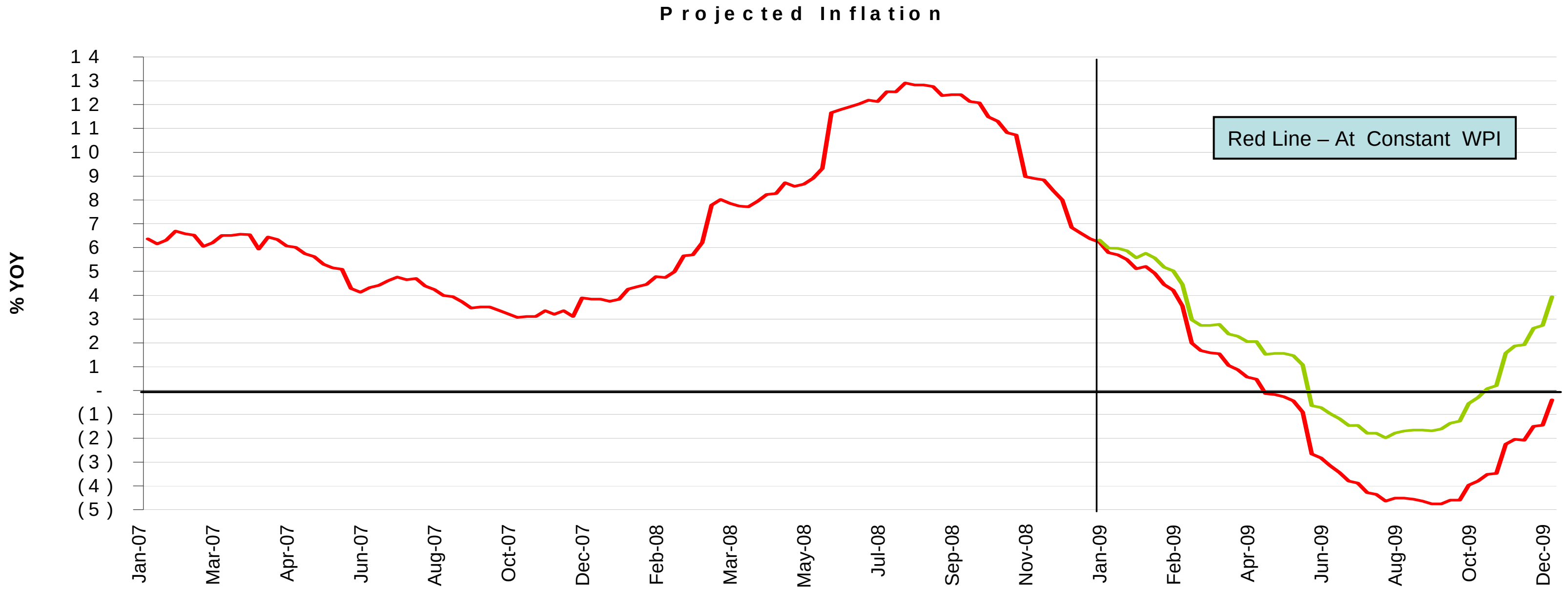
Projected inflation – likely to enter negative territory



Source: Bloomberg

- Falling fuel and commodity prices reflected in the recent fall in WPI inflation
- Inflation likely to head sharply lower in the coming months mainly on base effect of last year and due to lower commodity prices
- May enter negative territory by Jun-Aug 09 before rising again at the end of year

WSS Monthly Overview-Spotlights….

- M3 meagerly increases to 45,14,800 crs (Jan 16) from 44,30,231 crs (Dec 19)
- Total Deposits outstanding at 36,30,079 (Jan 16) versus 35,48,807 (Dec 19)
- Total Bank Credit outstanding at 26,45,160 (Jan 16) from 26,44,528 (Dec 19)
- Credit to Deposit ratio at 72.87 (Jan 16) from 74.52 (Dec 19)
- Investment in GoI Securities at INR 11,22,820 (Jan 16) versus 10,68,131 (Dec 19)
- Investment to Deposit ratio at 31.42 (Jan 16) from 30.60 (Dec 19)
- Total FX reserves decreased to 12,17,420 crs (Jan 26) from 12,20,869 (Dec 19)

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The month ahead...Global

- CDS spreads continue to remain wide signaling risk aversion continues
- USD expected to strengthen on risk aversion
- Crude expected to trade in the range of USD 45-55 per barrel on reduction in demand following global recession
- BoE expected to slash rates further towards the 0% levels
- BoJ expected to begin quantitative easing as rates fall to near zero levels
- Avoiding deflation is the main focus for major developed economies
- US Treasury yields to remain low as recession deepens

Current Economic Scenario-signaling contraction

- Economy continues to slowdown
  - Growth declines below its long-term average (expected to grow at 5.5%-6.00%)
- Commodities continue to decline
  - Decline is quite visible
- Short-term rates continue to decline
  - Monetary measures continue to push the short-term rates down
- Long-Term Gilt yields continue to decline, though short-term volatility persists
  - Credit risk aversion has pushed the gilt yields down
- Inflation continues to ease
  - Declining commodity prices help ease WPI
  - Weaker demand for goods due to slower growth dampening prices

What to expect in 2009

- Both industrial and developing economies likely to contract
- Pro-active fiscal and monetary measures likely to counter economic slowdown
- Investments likely to witness considerable slowdown
- Uncertain outlook on growth and tax revenues is uncertain and FY 09-10 fiscal requirements will be large
- Financing additional expenditures of INR350bn could be through bonds rather than T-bills
- Given cross-border tensions, Defense expenditure could rise for next fiscal
- With Bank NPLs expected to rise, credit growth may not be as expected (target of 24% by RBI)
- Spread compression between sovereign and corporate bonds may not happen in a hurry

The month ahead...Domestic

- Gilts yields likely to be volatile in the near term
- Short-term rates likely to remain easy
- Arresting slowdown in growth remain priority for the Government and RBI
- RBI likely to cut key policy rates further in the quarter
- 10 yr GOI yield likely to trade in a range of 5.75%-6.25% while targeting an eventual move towards 5.00% levels
- Inflation expectation for the month ahead in the range of 4.5 to 5%
- Likely additional borrowing from the government may result in steepening of the gilt yield curve
- Incoming macro data likely to continue to disappoint

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Suggested Strategies For the Month Ahead

- Macro fundamentals suggest continuity of weak data in the months ahead
- RBI likely to lower policy rates by another 50-100 basis points though timing remains uncertain
- Immediate upward pressure on yields comes from more supply from the Government
- Yield curve likely to steepen as market braces for more supply
- We have reduced duration on our long term debt funds and await details of the revised auction calendar which is likely to be announced mid-Feb
- We continue to play spread trades in the liquid gilt segment as volatility is likely to persist in the short term
- Do not recommend increasing exposure to the long end of the yield curve till there is clarity on additional fiscal borrowing

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